

Office of the State Auditor

Division of State Audit

Department of Financial Institutions Bismarck, North Dakota

Audit Report for the
Two-Year Period Ended June 30, 2006
Client Code 413

Robert R. Peterson
State Auditor



LEGISLATIVE AUDIT AND FISCAL REVIEW COMMITTEE MEMBERS

Representative Bob Skarphol – Chairman
Senator Randel Christmann – Vice Chairman

Representatives

Ole Aarsvold
Larry Bellew
Merle Boucher
Kari Conrad
Jeff Delzer
Bette Grande
Patrick Hatlestad
RaeAnn G. Kelsch
Kenton Onstad
Louis Pinkerton
Bob Skarphol
Blair Thoreson
Francis Wald

Senators

Randel Christmann
Dwight Cook
Jerry Klein
Judy Lee
Harvey Tallackson

You may obtain reports by contacting the
Division of State Audit
at the following address:

Office of the State Auditor
600 East Boulevard Avenue – Department 117
Bismarck, ND 58505-0060
(701) 328-2241

Reports are also available on the internet at:
www.nd.gov/auditor/

Contents

<i>Transmittal Letter</i>	<i>1</i>
<i>Executive Summary</i>	<i>2</i>
<i>Introduction</i>	<i>2</i>
<i>Responses to LAFRC Audit Questions</i>	<i>2</i>
<i>LAFRC Audit Communications</i>	<i>3</i>
<i>Background Information</i>	<i>5</i>
<i>Audit Objectives, Scope, And Methodology</i>	<i>6</i>
<i>Discussion And Analysis</i>	<i>7</i>
<i>Financial Summary</i>	<i>7</i>
<i>Financial Statements</i>	<i>8</i>
<i>Statement of Revenues and Expenditures</i>	<i>8</i>
<i>Statement of Appropriations</i>	<i>9</i>
<i>Internal Control</i>	<i>11</i>
<i>Compliance With Legislative Intent</i>	<i>12</i>
<i>Noncompliance With Biennial Cash Balance Limit</i>	<i>13</i>
<i>Operations</i>	<i>15</i>
<i>Management Letter (Informal Recommendations)</i>	<i>16</i>

Transmittal Letter

April 19, 2007

The Honorable John Hoeven, Governor
Members of the North Dakota Legislative Assembly
Tim Karsky, Commissioner

We are pleased to submit this audit of the Department of Financial Institutions for the two-year period ended June 30, 2006. This audit resulted from the statutory responsibility of the State Auditor to audit or review each state agency once every two years. The same statute gives the State Auditor the responsibility to determine the contents of these audits.

In determining the contents of the audits of state agencies, the primary consideration was to determine how we could best serve the citizens of the state of North Dakota. Naturally we determined financial accountability should play an important part of these audits. Additionally, operational accountability is addressed whenever possible to increase efficiency and effectiveness of state government.

The in-charge auditor for this audit was Angela Klubberud. Andrea Wike and Aaron Petrowitz were the staff auditors. Cindi Pedersen, CPA, was the audit supervisor. Inquiries or comments relating to this audit may be directed to the audit supervisor by calling (701) 328-4743. We wish to express our appreciation to Commissioner Karsky and his staff for the courtesy, cooperation, and assistance they provided to us during this audit.

Respectfully submitted,

Robert R. Peterson
State Auditor

Executive Summary

INTRODUCTION

The Department of Financial Institutions is a regulatory agency exercising oversight responsibilities of financial institutions in North Dakota. The Department has charge of the execution of all laws relating to state banks, trust companies, building and loan associations, mutual investment corporations, mutual savings corporations, banking institutions, and other financial corporations, examination authority over the Bank of North Dakota, and all credit unions organized or doing business under the laws of this state. The Department conducts examinations of state chartered banks, the Bank of North Dakota, state chartered credit unions, consumer finance companies, and agents for deposit. Additionally, the Department issues licenses to money brokers, collection agencies, and money transmitter businesses. The Department is responsible to the depositors and creditors of the financial institutions by determining the soundness of the financial institutions and monitoring compliance with applicable rules and regulations.

RESPONSES TO LAFRC AUDIT QUESTIONS

The Legislative Audit and Fiscal Review Committee (LAFRC) requests that certain items be addressed by auditors performing audits of state agencies.

1. What type of opinion was issued on the financial statements?

Financial statements were not prepared by the Department of Financial Institutions in accordance with generally accepted accounting standards so an opinion is not applicable. The agency's transactions were tested and included in the state's basic financial statements on which an unqualified opinion was issued.

2. Was there compliance with statutes, laws, rules, and regulations under which the agency was created and is functioning?

Other than our finding addressing "noncompliance with biennial cash balance limit" (see page 13), the Department of Financial Institutions was in compliance with significant statutes, laws, rules, and regulations under which it was created and is functioning.

3. Was internal control adequate and functioning effectively?

Yes.

4. *Were there any indications of lack of efficiency in financial operations and management of the agency?*

No.

5. *Has action been taken on findings and recommendations included in prior audit reports?*

The Department of Financial Institutions has implemented all recommendations included in the prior audit report.

6. *Was a management letter issued? If so, provide a summary below, including any recommendations and the management responses.*

Yes, a management letter was issued and is included on page 16 of this report, along with management's response.

LAFRC AUDIT COMMUNICATIONS

1. *Identify any significant changes in accounting policies, any management conflicts of interest, any contingent liabilities, or any significant unusual transactions.*

There were no significant changes in accounting policies, no management conflicts of interest were noted, no contingent liabilities were identified or significant unusual transactions.

2. *Identify any significant accounting estimates, the process used by management to formulate the accounting estimates, and the basis for the auditor's conclusions regarding the reasonableness of those estimates.*

The Department of Financial Institutions' financial statements do not include any significant accounting estimates.

3. *Identify any significant audit adjustments.*

Significant audit adjustments were not necessary.

4. *Identify any disagreements with management, whether or not resolved to the auditor's satisfaction relating to a financial accounting, reporting, or auditing matter that could be significant to the financial statements.*

None.

5. *Identify any serious difficulties encountered in performing the audit.*

None.

6. *Identify any major issues discussed with management prior to retention.*

This is not applicable for audits conducted by the Office of the State Auditor.

7. *Identify any management consultations with other accountants about auditing and accounting matters.*

None.

8. *Identify any high-risk information technology systems critical to operations based on the auditor's overall assessment of the importance of the system to the agency and its mission, or whether any exceptions identified in the six audit report questions to be addressed by the auditors are directly related to the operations of an information technology system.*

ConnectND Finance, Human Resource Management System (HRMS), and the Records Management System are high-risk information technology systems critical to the Department of Financial Institutions.

Background Information

The mission of the Department of Financial Institutions is to maintain public confidence in North Dakota financial institutions by ensuring the financial industry operates in a safe and sound manner while complying with applicable rules and laws.

Tim Karsky, Commissioner, who is appointed by the Governor and confirmed by the North Dakota Senate, heads the Department of Financial Institutions.

The Department of Financial Institutions has charge of the execution of all laws relating to state banks, trust companies, building and loan associations, mutual investment corporations, mutual saving corporations, banking institutions, other financial corporations, and all credit unions organized or doing business under the laws of this state as well as examination authority over the Bank of North Dakota. The Department of Financial Institutions also issues licenses to money brokers, collection agencies, small loan companies, consumer finance companies, deferred presentment service providers (payday lenders), agents for deposits, and money transmitter businesses.

The Department of Financial Institutions is comprised of three divisions:

- Banking Division
 - Credit Union Division
 - Consumer Division
-

The Department of Financial Institutions regulates the financial services providers mentioned above through three divisions. The Banking Division regulates state-chartered banks and independent trust companies. The Credit Union Division regulates state-chartered credit unions. The Consumer Division regulates money brokers, deferred presentment service providers (payday lenders), consumer finance companies, collection agencies, and money transmitter companies.

The Commissioner, in conjunction with the State Banking Board (seven members) and State Credit Union Board (five members), provides supervisory authority over North Dakota state-chartered banks and credit unions. All members of these Boards are appointed by the Governor. The Commissioner serves as chairperson on each Board.

The North Dakota Department of Financial Institutions' budget for the 2003-2005 biennium totals \$3,711,384. The Department of Financial Institutions' budget for the 2005-2007 biennium totals \$4,445,503. This represents a 19.8% increase over the 2003-2005 budget. There were no state general funds included in the Department's current budget.

More information can be obtained from the Department of Financial Institutions home page at: www.nd.gov/dfi.

Audit Objectives, Scope, And Methodology

Audit Objectives

The objectives of this audit of the Department of Financial Institutions for the two-year period ended June 30, 2006 were to provide reliable, audited financial statements and to answer the following questions:

1. What are the most important areas of the Department of Financial Institutions' operations and is internal control adequate in these areas?
2. What are the significant and high-risk areas of legislative intent applicable to the Department of Financial Institutions and are they in compliance with these laws?
3. Are there areas of the Department of Financial Institutions' operations where we can help to improve efficiency or effectiveness?

Audit Scope

This audit of the Department of Financial Institutions for the two-year period ended June 30, 2006 was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. To meet the objectives outlined above, we:

Audit Methodology

- Prepared financial statements from the legal balances on the state's accounting system tested as part of this audit and the audit of the state's Comprehensive Annual Financial Report and developed a discussion and analysis of the financial statements.
- Performed detailed analytical procedures for expenditures.
- Tested samples of expenditures, journal vouchers, and correcting entries.
- Reviewed prior year audit workpapers.
- Interviewed appropriate agency personnel.
- Reviewed Department of Financial Institutions' written plans and applicable manuals.
- Reviewed Department of Financial Institutions' biennial report.
- Observed Department of Financial Institutions' processes and procedures.
- Reviewed North Dakota Century Code chapters 6-01, 6-05, 6-06, 13-03.1, 13-04.1, 13-05, 13-08, 13-09, 51-17, and the 2003 and 2005 Session Laws.
- Conducted a review of the Records Management System.
- Reviewed industry best practices through the use of Internet searches.
- Searched for recent studies or reports relating to the Department of Financial Institutions.

Discussion And Analysis

The accompanying financial statements have been prepared to present the Department of Financial Institutions' revenues and expenditures on the legal (budget) basis. The accompanying financial statements are not intended to be presented in accordance with generally accepted accounting principles (GAAP).

For the two-year period June 30, 2006, operations of the Department of Financial Institutions were primarily supported by the collection of annual assessments and investigation, license, and special examination fees.

FINANCIAL SUMMARY

Revenues consisted primarily of bank and credit union assessment fees, consumer license fees, investigation fees, and special examination fees. Other revenue during the audited period included interest income earned on the Department of Financial Institution's operating fund and fines and penalties. Total revenues were \$1,990,146 for the fiscal year ended June 30, 2006 as compared to \$2,170,476 for the fiscal year ended June 30, 2005. Revenue was lower in 2006 due to a 25% credit authorized by the State Banking Board. The credit was given due to a large increase in total assets in the banking industry and a modest decrease in expenditure, partly due to savings in the salary line item because of turnover.

Total expenditures for the Department of Financial Institutions were \$2,091,094 for the year ended June 30, 2006 as compared to \$1,805,121 for the prior year. The increase in total expenditures for the audited period primarily reflects general increases in employee training and information technology needs due to the increasing number and types of licenses issued. All other expenditures remained fairly constant.

Financial Statements

STATEMENT OF REVENUES AND EXPENDITURES

	June 30, 2006	June 30, 2005
<u>Revenues and Other Sources:</u>		
Regulatory Fees	\$ 1,505,192	\$ 1,817,437
Licenses, Permits, and Fees	317,221	297,802
Fines and Forfeitures	125,900	26,950
Interest and Investment Earnings	31,219	16,178
Non-Business Licenses and Fees	8,750	4,500
Program Income	1,050	1,050
Miscellaneous Revenue	814	6,559
Total Revenues and Other Sources	\$ 1,990,146	\$ 2,170,476
<u>Expenditures and Other Uses:</u>		
Salaries and Benefits	\$ 1,581,051	\$ 1,452,116
Travel	166,716	158,652
Fees - Professional Services	73,753	33,340
Rentals/Leases - Building/Land	68,222	50,797
IT - Data Processing	64,622	25,421
Professional Development	59,453	20,370
Operating Fees and Services	29,315	18,322
IT - Communications	11,536	9,483
Supply/Material-Professional	7,307	7,091
Postage	6,421	6,644
Supplies - IT Software	5,696	
Insurance	4,016	3,112
Printing	3,932	960
Rentals/Leases - Equipment and Other	3,796	3,212
Office Supplies	3,271	2,293
IT Equipment under \$5,000	1,608	8,740
Other Operating Expenditures	379	4,568
Total Expenditures and Other Uses	\$ 2,091,094	\$ 1,805,121

STATEMENT OF APPROPRIATIONS

For The Fiscal Year Ended June 30, 2006

Expenditures by Line Item:	<u>Original Appropriation</u>	<u>Adjustments</u>	<u>Final Appropriation</u>	<u>Expenditures</u>	<u>Unexpended Appropriation</u>
Salaries and Benefits	\$ 3,412,279		\$ 3,412,279	\$ 1,530,007	\$ 1,882,272
Operating Expenses	811,982		811,982	461,480	350,502
Capital Assets	7,500		7,500		7,500
Contingency	20,000		20,000		20,000
Money Transmitters	193,742		193,742	98,423	95,319
Totals	<u>\$ 4,445,503</u>	<u>\$ 0</u>	<u>\$ 4,445,503</u>	<u>\$ 2,089,910</u>	<u>\$ 2,355,593</u>
Expenditures by Source:					
Other Funds	\$ 4,445,503		\$ 4,445,503	\$ 2,089,910	\$ 2,355,593
Totals	<u>\$ 4,445,503</u>	<u>\$ 0</u>	<u>\$ 4,445,503</u>	<u>\$ 2,089,910</u>	<u>\$ 2,355,593</u>

For The Biennium Ended June 30, 2005

Expenditures by Line Item:	<u>Original Appropriation</u>	<u>Adjustments</u>	<u>Final Appropriation</u>	<u>Expenditures</u>	<u>Unexpended Appropriation</u>
Salaries and Benefits	\$ 2,984,539	\$ (27,500)	\$ 2,957,039	\$ 2,870,051	\$ 86,988
Operating Expenses	672,726	81,619	754,345	745,795	8,550
Totals	<u>\$ 3,657,265</u>	<u>\$ 54,119</u>	<u>\$ 3,711,384</u>	<u>\$ 3,615,846</u>	<u>\$ 95,538</u>
Expenditures by Source:					
Other Funds	\$ 3,657,265	\$ 54,119	\$ 3,711,384	\$ 3,615,846	\$ 95,538
Totals	<u>\$ 3,657,265</u>	<u>\$ 54,119</u>	<u>\$ 3,711,384</u>	<u>\$ 3,615,846</u>	<u>\$ 95,538</u>

Appropriation Adjustments:

The increase in the Operating Expenses (\$81,619) includes increased spending authority from Salaries and Benefits (\$27,500) for additional travel and training expenditures. The adjustment was properly approved by the Emergency Commission.

The remaining increase in the Operating Expenses (\$54,119) includes increased spending authority for legal fees and Financial Literacy Training. The adjustment was properly approved by the Emergency Commission.

Internal Control

In our audit for the two-year period ended June 30, 2006, we identified the following areas of the Department of Financial Institutions' internal control as being the most important:

Internal Controls Subjected To Testing

- Controls surrounding the processing of revenues.
- Controls surrounding the processing of expenditures.
- Controls effecting the safeguarding of assets.
- Controls relating to compliance with legislative intent.
- Controls surrounding the ConnectND (PeopleSoft) system.
- Controls surrounding the computer-based Records Management System.

We gained an understanding of internal control surrounding these areas and concluded as to the adequacy of their design. We also tested the operating effectiveness of those controls we considered significant. We concluded internal control was adequate. Our consideration of internal control would not necessarily disclose all matters that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements that would be material may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving internal control and its operation that we consider to be material weaknesses. However, we noted other matters involving internal control that we have reported to management of the Department of Financial Institutions in a management letter dated April 19, 2007.

Compliance With Legislative Intent

In our audit for the two-year period ended June 30, 2006, we identified and tested the Department of Financial Institutions' compliance with legislative intent for the following areas that we determined to be significant and of higher risk of noncompliance:

Legislative Intent Subjected To Testing

- Maintained proper cash balance in the Financial Institutions Regulatory Fund at the close of the biennium (NDCC 6-01-01.1).
- Proper State Banking Board member reimbursements (NDCC 6-01-03).
- Proper assessments, penalties, application fees, and examiner fees were charged.
- Compliance with agency appropriation laws (Chapter 8 of the 2003 Session Laws and Chapter 36 of the 2005 Session Laws).
- Proper use of the State Treasurer (State Constitution, article X, section 12).
- Compliance with OMB's Purchasing Procedures Manual.
- Travel-related expenditures were made in accordance with OMB policy and state statute.
- Compliance with fixed asset requirements including record keeping, surplus property, lease and financing arrangements in budget requests, and lease analysis requirements.
- Compliance with payroll related laws including statutory salaries for applicable elected and appointed positions, and certification of payroll.

The results of our tests disclosed one instance of noncompliance which is required to be reported under *Government Auditing Standards*. The finding is described on the following page. Other than that finding, we concluded there was compliance with the legislative intent identified above.

NONCOMPLIANCE WITH BIENNIAL CASH BALANCE LIMIT

Finding 06-1

The cash balance in the financial institutions regulatory fund at the end of the 2003-2005 biennium exceeded the amount allowed per North Dakota Century Code (NDCC) section 6-01-01.1 (3). The fund's cash balance at the end of the biennium was \$1,224,088 which exceeded the amount allowed by \$334,987.

NDCC section 6-01-01.1 (3) states that "any cash balance in the financial institutions regulatory fund after all current biennium expenditures are met must be carried forward in the financial institutions regulatory fund for the next succeeding biennium. The balance in this fund at the end of the current biennium may not exceed twenty percent of the department's biennial budget." The department's budget for the 2005-2007 biennium was \$4,445,503 which allowed a cash carryover of \$889,101 at the end of the 2003-2005 biennium.

We recognize NDCC section 6-01-01.1 (3) is ambiguous regarding the cash balance limitation. This section does not specify to which fund the excess balance should be transferred, nor does it specify which biennial budget to use when computing "twenty percent of the department's biennial budget".

Audit Recommendation and Agency Response

Recommendation:

We recommend that the Department of Financial Institutions:

1. Ensure the cash balance in the Financial Institutions Regulatory Fund at the end of the biennium not exceed twenty percent of the department's biennial budget in accordance with section 6-01-01.1 (3) of the North Dakota Century Code.
2. Introduce legislation to clarify NDCC section 6-01-01.1 (3).

Department of Financial Institutions' Response:

As indicated during the audit, the Department receives license renewal fees for the entities that we issue annual licenses for, such as money brokers, deferred presentment service providers, money transmitters, consumer finance companies, and collection agencies. As you are aware, the licensees are required to submit their renewal applications 30 days before the expiration of the license. The Department starts the renewal process in March of every year and collects the majority of all license renewal fees before June 30. As indicated above, the language is somewhat ambiguous and the Department does not believe it is the legislators' intent that fees collected for the future biennium should be included in the carryover balance of the regulatory fund. These fees are needed to regulate the above industries in the coming

year. If you subtract the amount of fees the Department collected before June 30, 2005, the carryover balance would only exceed the 20% limitation by \$38,073. The Department will be asking the Legislature for additional positions in the upcoming legislative session to help regulate the above industries. We believe the carryover issue will be significantly reduced as these funds will be used to pay the salaries and benefits and the cost of regulating these industries.

Operations

This audit did not identify areas of the Department of Financial Institutions' operations where we determined it was practical at this time to help to improve efficiency or effectiveness.

Management Letter (Informal Recommendations)

April 19, 2007

Mr. Tim Karsky
Commissioner
Department of Financial Institutions
2000 Schafer Street, Suite G
Bismarck, North Dakota 58501-1204

Dear Mr. Karsky:

We have performed an audit of the Department of Financial Institutions for the two-year period ended June 30, 2006, and have issued a report thereon. As part of our audit, we gained an understanding of the Department of Financial Institutions' internal control structure to the extent we considered necessary to achieve our audit objectives. We also performed tests of compliance as described in the same report.

Our audit procedures are designed primarily to enable us to report on our objectives including those related to internal control and compliance with laws and regulations and may not bring to light all weaknesses in systems and procedures or noncompliance with laws and regulations which may exist. We aim, however, to use our knowledge of your organization gained during our work to make comments and suggestions which we hope will be useful to you.

In connection with the audit, gaining an understanding of the internal control structure, and tests of compliance with laws and regulations referred to above, we noted certain conditions we did not consider reportable within the context of your audit report. These conditions relate to areas of general business practice or control issues that have no significant bearing on the administration of federal funds. We do, however, want to present our recommendations to you for your consideration and whatever follow-up action you consider appropriate. During the next audit we will determine if these recommendations have been implemented, and if not, we will reconsider their status as non-reportable conditions.

The following present our informal recommendations.

LEGISLATIVE INTENT

Informal Recommendation 06-1: The Department of Financial Institutions should manually review and approve journal entries for the general ledger after they have been posted by the Office of Management and Budget until OMB implements the general ledger online approval function.

Informal Recommendation 06-2: The Department of Financial Institutions' annual physical inventory should be taken by someone who has no custodial or record keeping responsibilities.

Management of the Department of Financial Institutions agreed with the recommendations.

I encourage you to call myself or an audit manager at 328-2320 if you have any questions about the implementation of recommendations included in your audit report or this letter.

Sincerely,

Angela Klubberud
Auditor in-charge